

MCI urges a comprehensive move to the five elements of its "True Price Cap" plan and the simultaneous elimination of the "inflation minus productivity" component of the current NRF price cap formula.¹⁴⁹ TURN advises that if revisions to NRF are permitted, they should be contingent on the achievement of effective competition for local service, and should only follow resolution of the issues necessary to ensure that competition can succeed. TURN asserts that while the process evolves it needs to be measured and monitored carefully within the NRF framework.¹⁵⁰

CCTA proposes a milestones timetable that would permit regulatory relief based on the "openness of the marketplace" rather than measures of market share alone. CCTA's approach measures the ease with which market entrants can enter and/or exit new markets. It ties regulatory milestones to four indices of the openness of a market to competition: number portability; equal access to the LECs' customer database; equal access to basic monopoly network building blocks; and the elimination of the dialing disparity for intraLATA toll providers.¹⁵¹ CCTA sets forth a formula for measuring the achievement of the milestones.

¹⁴⁹ MCI Brief at 4.

¹⁵⁰ TURN Comments at 18; TURN Brief at 25-26.

¹⁵¹ CCTA Brief at 12.

AT&T concurs with the LECs assertion that it is inappropriate to reduce rates for services that are already priced below total service long run incremental cost (TSLRIC). AT&T submits that driving below-cost rates further below cost is economically irrational and may foreclose the development of effective competition for services so priced. Thus, the company recommends that the Commission modify the application of NRF price cap adjustments so that any service "demonstrated" to be priced at or below TSLRIC is exempted from downward price-cap adjustments until its rate rises above TSLRIC. In addition, AT&T suggests that, if the Commission insists upon making price cap mechanism reductions at this time, several additional milestones be adopted in order to encourage the LECs to remove certain "significant barriers to entry into their markets."¹⁵² It insists that any "X" factor reductions linked to LEC achievement of the milestones should be applicable only to the "stretch" component of the factor. Since AT&T estimates the stretch component to comprise approximately 1% of the "X" factor, the company suggests that the milestones be tied to discrete reductions.¹⁵³

¹⁵² AT&T Brief at 61.

¹⁵³ "[A] .25% reduction upon implementation of intraLATA equal access in 90% of a LEC's exchanges; a .25% reduction upon implementation of the Commission-adopted permanent number

Discussion

Although the PD expressed surprise at the LECs strongly negative reaction to the idea of modifying the framework in recognition of the attainment of certain milestone events as we move towards January 1, 1997, we do not share that surprise. Any step that complicates our current regulatory process by further encumbrances is a step in the wrong direction, and inconsistent with our overall strategy to reduce regulation as markets open. In our view, although milestones may appear to offer a reasonable approach, the complexity and multiplicity of regulatory proceedings now underway have stretched the managerial capacities of the Commission so seriously that we are uncertain that the results of this apparently reasonable approach would prove reasonable in fact.

We find the analysis of the PD compelling on this point. The PD found that:

"The parties' proposals presented a variety of problems. Pragmatically, CCTA's recommendation, considering

portability solution in 90% of the LEC's exchanges; a .30% reduction upon Commission approval of cost-based, fully-unbundled network and interconnection tariffs; and a .20% reduction upon effective removal of all tariffed use and user restrictions and execution of the inter-company arrangements necessary for resale competition to begin." (Id.)

Dr. Wolak's formula, appears to be administratively complex. DRA's proposal to eliminate the "stretch" component of the "X" factor after the projected implementation of interim facilities-based local competition on January 1, 1996, and the projected adoption and implementation of interim rules for bundled resale-based competition on March 1, 1996, appears arbitrary without additional record support. It has not been shown, given the evidence before us, that the value of the "incremental" risk confronting the LECs in local exchange competition is equivalent to the "X" factor's 50 basis points "stretch" component, or substantially more or less. As we stated above, the evidence on measurement of the increasing level of competition and competitive risk was inadequate.

Simplified, DOD/FEA's proposal to surcharge underpriced services and surcredit overpriced services, discussed earlier, calls for the repricing of services to cost. This is the endeavor of the OANAD proceeding. New cost studies should establish the foundation for the resetting of prices. DOD/FEA also suggests that the Commission consider, in Phase II, giving credits

to the LECs for the reductions that they make in reaction to competition. While this recommendation establishes a process similar to the "baskets" approach used by the FCC, and would appear to resolve the LECs' complaints about "double jeopardy" or "double hits," this process could be administratively burdensome unless the Commission adopts the "baskets" approach.¹⁵⁴

One of the identified problems with the current price cap formula is that it lowers the price of services that may already be below cost. AT&T's milestone proposal attempts to resolve this problem by simply not applying the price cap formula to such services. We find this proposal conceptually attractive, but problematic to adopt. It is unclear whether or not under AT&T's approach the reduction in revenue requirement gets assigned to the remaining services. Also, it is not apparent what the treatment should be for services priced just barely above cost, and how often cost studies will be updated. Finally,

¹⁵⁴ Moreover, a number of issues must be addressed: 1) What if the credited service gets recategorized? 2) How is the reduction to be weighted (i.e. a 10% reduction for a minor service may be financially smaller a 5% reduction for major service)? 3) Is stimulation estimated and/or considered? 4) Is market loss a relevant factor?

AT&T's proposal seems to be further complicated by the issue of shared costs. Shared costs need to be assigned to groups of services, but not necessarily any one service. By moving shared costs among different services, the "cost" of a service will change. Overall, AT&T's recommendation appears to be administratively unfeasible.

After carefully considering the potential difficulties posed by the parties' various proposals, we completely agree with the Proposed Decision and reject a milestone approach to modifying the NRF at this time. The Commission's decision to review the NRF dates to November of 1989 when the Commission indicated that it anticipated another review in 1995. In D.94-06-011, the Commission scheduled a review of NRF to begin in January 1995. The Commission rejected a proposal to delay the NRF review until 1996. The Commission stated "the next review should begin as originally scheduled in order to direct us toward our Infrastructure Report goal of 1997."

Much has changed since June of 1994 when we completed our last review of NRF. In April of 1995, we opened the intraLATA toll market to competition. In D.95-04-075, we opened the Local Transport and Switched Access market to competition. Last month, in D.95-12-020, the Commission modified its previous order opening the Local Transport market to accept a settlement

that will establish the rate unbundling to make competition in this market a reality. This leaves only the local telecommunications market as the remaining market to be opened to competition. In D.95-07-054, we directed that this last market be opened to competition. We stated that entry in the local market would be allowed January 1 of 1996. We fully anticipate that this will occur and anticipate the certification of many of the 40 facilities based competitive local telephone companies that have sought certification. In addition, we anticipate further opening this market on March 1, 1996 when we allow resale competition to begin.

We anticipate that our order in I.95-05-047 will address several of the milestones identified by parties in the proceeding. We anticipate issuance of interconnection rules that will provide the LECs and CLCs guidance on the content of interconnection agreements, establish an expedited approval process, and design a streamlined dispute resolution process. In D.95-07-054, the Commission ordered bill-and-keep compensation as the preferred mode of reciprocal intercarrier compensation agreements. In addition, we anticipate the Commission will address the issue of meet-point billing as well. We fully anticipate issuing a decision in I.95-04-043 concurrent with the issuance of this decision.

A great deal of change has occurred in the telecommunications market since NRF was modified in June of 1994. Given the extent of the progress we have made in opening up the markets, we do not find it necessary to await further changes. Contrary to the various proposals in the record that recommend modification of NRF in tandem with progress in other dockets, we will not use the NRF review as a regulatory carrot tied to the achievement of milestones in other proceedings. The Commission is fully capable of setting and meeting its own schedule.

Findings of Fact

1. Each service category in NRF grants different levels of pricing freedom.

2. As a significant aspect of the NRF, the Commission granted LECs the authority to seek the transfer of a service from a more restrictive to a less restrictive Category, upon a showing that competition for that service has developed to the point where it meets the criteria for inclusion in the less restrictive category.

3. Pacific and GTEC provided substantial evidence of the entry into newly opened telecommunications markets and the emergence of competition in California.

4. Pacific's presentation on the level of competition now emerging in California consisted of expert testimony describing

and evaluating studies of competition in telecommunications markets, various statistics, press releases, and newspaper reports related to competition in the LECs' markets.

5. Part of the problem carriers face in showing the level of competition in the telecommunications industry is that, while significant evidence for competition in the intraLATA toll market was demonstrated, the relevant evidence for competition in the local exchange market does not exist.

6. The LECs' showing allays many of our concerns about the transition from significant to declining market power.

7. Pacific's report that it currently carries only 56% of the California intraLATA business toll traffic suggests that Commission regulatory policies to open all toll markets are succeeding.

8. Pacific's data on HiCap services reveals that Commission regulatory policies to open this telecommunications market segment are succeeding in the largest markets.

9. Pacific reports a loss of approximately 6% market share for intraLATA toll services since January 1, 1995 as a result of 10XXX switched toll bypass.

10. Not calculating misdialed calls, GTEC indicates a loss of 7.5 percent market share of switched toll calling for the first six months of 1995.

11. Declining intraLATA toll market share is a significant, though not conclusive, element, in indicating the pace of competition and the projected competitive impacts that the LECs might sustain.

12. The LECs' intraLATA toll market share numbers reflect the growth of competition in that market before and after the official opening of the market in January, 1995.

13. It is to be expected that when competition is introduced into a market previously served by a monopoly provider there will be a loss of market share by that provider.

14. The evidentiary record does indicate that the speed of LECs' intraLATA toll market share loss is extraordinary.

15. Dr. Harris' testimony supports the LECs' contention that they are facing rising competition in some of their Category II services.

16. Although the bulk of the evidence presented by the LECs on the pace and power of competition on Category II services relate to toll services, it nonetheless shows a reduced market share for Pacific Bell and GTEC in the post-NRF period.

17. The LECs envision fierce competition in the local exchange market in the immediate future.

18. The LECs' showing indicates that several Category II services face increasing competition.

19. The LECs' intraLATA toll market share numbers reflect the growth of competition in that market before and after the official opening of the market in January, 1995.

20. Not all Category II services are effectively competitive.

21. The fact that the LECs face more competition in the toll markets today and that the degree of competition will increase once the remaining local markets are opened, are indicators of the movement towards a more competitive market.

22. The evidentiary record supports the view that some of the decline in Pacific's revenues is the result of GDPPI minus "X".

23. From 1984-1989, Pacific's normalized revenues grew at 2.8% compound annual growth rate, while in the 1990-1994 period under incentive regulation, its revenues grew at only a 0.2% compound annual growth rate.

24. Pacific's net income growth during the 1990-1994 period under incentive regulation declined at a 2.2% compound annual growth rate, compared to a positive 7.2% compound annual growth rate for the 1984-1989 period.

25. Pacific's return on equity for the 12-month period ending June 30, 1995 was commensurate with other RBOCs.

26. Pacific Telesis Group's dividend yield is 8.1%, the highest of the RBOCs.

27. Commission data show that Pacific's 1995 year-to-date ROR is 8.92.

28. Commission data show that GTEC's 1995 year-to-date ROR is 8.602.

29. Pacific revenues have shown little or no growth in recent years. GTEC's revenues have actually declined since 1991.

30. Time constraints prevented a full exploration of Pacific's contention that the 1994 spinoff of PacTel and its wireless subsidiaries has had no effect on the LEC's financial picture.

31. Pacific's and GTEC's revenue trajectory is the result of numerous factors, including the California economy, competition, and the effects of NRF.

32. Sole reliance on "historical productivity data" is not appropriate given the changes in the environment in which LECs operate.

33. Dr. Christensen's revision of his study by using newer estimates of data is consistent with professional practice.

34. Dr. Christensen's finding of a 2.1% TFP is consistent with those found in a series of studies covering different historical periods.

35. The methodology that was used to gather the data, upon which Dr. Christensen's productivity factor study relies, was based on specification provided by the BLS.

36. Dr. Selwyn's 5.7% productivity factor proposal is problematic because it includes an unsupportable input price differential.

37. The record on LEC input prices shows that the difference between input price growth for the US economy and input price growth for the LEC industry is not statistically different from zero.

38. Dr. Selwyn's productivity factor proposal includes a total productivity differential of 2.6% based on a previous Christensen study.

39. Key issues that may affect the regulation of Pacific Bell and GTEC are currently being considered in several on-going proceedings.

40. Linking regulatory actions to the attainment of certain milestones complicates the Commission's efforts to open all California telecommunications markets by January 1, 1997.

41. Since Pacific has already become highly efficient, additional efficiencies will be more difficult to achieve.

42. The settlement agreed to by GTEC and other parties in A.92-05-002 and adopted by D.93-09-038 set the productivity

factor for GTEC for calendar years 1993, 1994, 1995, and 1996 at 4.5%, 5.0%, 4.8%, and 4.6%, respectively.

43. "Z" factor adjustments are not affected by the suspension of the price cap formula for GTEC and Pacific Bell.

44. Suspension of the price cap formula is tantamount to a reduction in the currently effective productivity factor, provided inflation rates for 1996, 1997, and 1998 remain below 5%.

45. Suspension of the price cap formula will produce a zero differential between GDPPI and the "X" factor resulting in neither an increase nor a decrease in Pacific and GTEC's revenues for each calendar year the formula will be suspended.

Conclusions of Law

1. The record amply supports a finding that Pacific and GTEC are facing significant and increasing competition in their markets.

2. Pacific and GTEC should not be exempted from a freeze on the prices caps for all Category I and II services at this time.

3. It is inappropriate to eliminate the price cap regulation until the Commission has found that effective local competition exists.

4. Freezing the price of all LEC Category I and II

services produces rates that remain reasonable.

5. Pacific's declining revenues should be regarded as the result of numerous factors, including the effects of NRF.

6. The Christensen study's 2.1% productivity factor recommendation is a reasonable measure of the difference between productivity for the LEC industry and for the U.S. economy as a whole.

7. Dr. Selwyn's productivity factor proposal of 5.7% should not be adopted as the value of an "X" factor for use in regulation based on the application of a price cap formula.

8. The current productivity factor of 5.0% adopted in D.94-06-011 should not continue to be used because evidence supports modification of our current regulatory program.

9. Pacific's prices for Category I services should be capped at current levels for calendar years 1996, 1997, and 1998, except for Commission approved rate increases above the price caps, Z factor adjustments, or until future order of the Commission.

10. GTEC's prices for Category I services should be capped at the then current levels on 1/1/97 for calendar years 1997 and 1998, except for Commission approved rate increases above the price caps, Z factor adjustments, or until future order of the Commission.

11. There is no pricing flexibility for Category I services.

12. Pacific's currently effective prices for Category II services should be capped as price ceilings for calendar years 1996, 1997, and 1998 with the exception of Z factor adjustments and Commission approved applications for increases above the rate caps.

13. GTEC's then currently effective prices for Category II services at 1/1/97 should be capped as price ceilings for calendar years 1997 and 1998 with the exception of Z factor adjustments and Commission approved rate increases through an application process.

14. Price caps on Category II services do not limit a LEC's ability to change Category II prices between the price cap and the price floor.

15. The Commission should continue to consider the degree to which competition has developed in a telecommunication market.

16. The Commission should modify NRF as telecommunications markets open and the levels of competition develop.

17. The Commission should not eliminate price cap regulation at this time.

18. It is reasonable to suspend the application of the price cap formula and thereby effectively set the productivity factor Pacific Bell and GTEC at the prevailing rate of inflation.

19. It is not reasonable to adopt a price differential adjustment at this time.

20. The Commission should not eliminate the price cap for all Category II services until it is clear that such action will not impede competition or harm ratepayers.

21. It is not reasonable to adopt a price differential of adjustment at this time.

22. CCTA's proposal to modify the price cap formula with the addition of a Q factor could not feasibly be implemented before the Commission examines the issue of service quality and should not be adopted.

23. MCI's "True Price Cap" proposal looks to the resolution of a number of cost issues better left to the OANAD proceeding and should not be adopted at this time.

24. In light of the potential difficulties posed by the parties' various proposals and the inherent difficulties of managing contingent regulatory actions, the Commission should not adopt a milestone approach to modifying the NRF at this time.

25. A productivity factor of 4.6% should be applied to GTEC for calendar year 1996 pursuant to the settlement.

26. GTEC may seek modification of D.93-09-038 to extend the suspension of the price cap formula to GTEC for 1996 in light of the reduced productivity adopted for Pacific Bell by this Order.

27. Price caps for Category I and Category II services, with the exception of Z factor adjustments, for use in the price cap filings of Pacific for 1996, 1997, and 1998, and GTEC for 1997 and 1998 will ensure that telecommunications rates remain reasonable.

28. A cap freezing prices for Category I and Category II services, with the exception of Z factor adjustments, for use in the price cap filings of Pacific for 1996, 1997, and 1998, and GTEC for 1997 and 1998 will end the reductions in operating revenues that have been associated with the use of a productivity factor of 5%.

29. The projected trajectory of revenues is a factor that influences the ability of firms to acquire investment capital.

30. In light of the potential difficulties posed by the various proposals and the inherent difficulties of managing contingent regulatory actions, the Commission should not adopt a milestone approach to modifying NRF.

INTERIM ORDER

IT IS ORDERED that:

1. Pacific Bell's (Pacific) prices for Category I services are capped at current levels for calendar years 1996, 1997, and 1998 except for Commission-approved rate increases above the price caps and Z factor adjustments. GTE California's (GTEC) prices for Category I services are capped at the then current levels on January 1, 1997 for calendar years 1997 and 1998 except for Commission-approved rate increases above the price caps and Z factor adjustments.

2. Pacific's currently effective prices for Category II services are capped as price ceilings for calendar years 1996, 1997, and 1998 with the exception of Z factor adjustments and Commission-approved applications for increases above the rate caps.

3. GTEC's then currently effective prices for Category II services at January 1, 1997 are capped as price ceilings for calendar years 1997 and 1998 with the exception of Z factor adjustments and Commission-approved rate increases through an application process.

4. Application of the GDPPI minus "X" formula of price cap regulation is suspended until a final decision is issued in the next triennial review of the incentive-based regulatory framework, currently anticipated to be undertaken in 1998, or until further order of the Commission.

5. The caps on Category I and Category II services shall remain in effect until a final decision is issued in the next triennial review of the incentive-based regulatory framework, currently anticipated to be undertaken in 1998, or until further order of the Commission.

6. The Commission Advisory and Compliance Division (CACD) shall prepare for Commission consideration a 1996 Price Cap Resolution for Pacific Bell that sets price caps for Category I and Category II services at current levels. On or before December 29, 1995, Pacific Bell shall file a supplement to Advice Letter No. 17762 to conform to this ordering paragraph.

This order is effective today.

Dated December 20, 1995, at San Francisco, California.

DANIEL Wm. FESSLER
President
P. GREGORY CONLON
JESSIE J. KNIGHT, JR.
HENRY M. DUQUE
JOSIAH L. NEEPER
Commissioners

I will file a written concurrence.

/s/ DANIEL Wm. FESSLER
Commissioner

APPENDIX A

List of Appearances

Respondents: Michael D. Sasser and Gregory L. Castle, Attorneys at Law, for Pacific Bell; and Michael J. Golabek, Attorney at Law, for GTE California, Incorporated.

Interested Parties: Davis Wright Tremaine, by Joseph S. Faber, Attorney at Law, for the California Committee for Large Telecommunications Consumers; Cecil O. Simpson, Jr., Attorney at Law, for the United States Department of Defense and all other Federal Executive Agencies; Mark E. Brown and William Harrellson, Attorneys at Law, for MCI Telecommunications Corporation; Barbara L. Snider and Jacqueline R. Kinney, Attorneys at Law, for Citizens Telecommunications Company of California, Inc.; Glenn Stover, Attorney at Law, for AT&T Communications of California, Inc.; Prima Legal Services, by Lee Burdick and Carrington F. Phillip, Attorneys at Law, for California Cable Television Association; Kathleen O'Reilly and Thomas J. Long, Attorneys at Law, for Toward Utility Rate Normalization; T. Santora, for Communications Workers of America, District 9 AFL-CIO.

Division of Ratepayer Advocates: Janice Grau, Attorney at Law.

(END OF APPENDIX A)

CERTIFICATE OF SERVICE

I, Cheryl A. Peters hereby certify that on this 1st day of March, 1996 a true and correct copy of the foregoing **Reply Comments of Pacific Bell and Nevada Bell** was mailed, first class-postage prepaid, to the parties shown on the attached list.


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94-1

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